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Personal Income Tax

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*Pamphlet under Income*

# PERSONAL INCOME TAX

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**PREPARED FOR JACKSON & CURTIS**

**BY GEORGE McC. SARGENT OF THE BOSTON BAR**

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## The Personal Income Tax

The Federal Income Tax law which went into effect recently concerns persons and corporations. The tax on corporations does not differ materially from that imposed before, and is not considered in this summary; but the tax on persons adds a new burden and is of direct interest to everyone who has to do with an income of \$3,000 or over, whether as recipient in his own right or for another, or as payor or distributor; for any such person may be included in those who are required to make a return and pay the tax.

As is to be expected, a great many points are not made clear in the law. Light on some of these will doubtless be thrown by the regulations of the Treasury Department when they are issued. In making the following summary an effort has been made to state in a broad and general way what it is conceived was intended should be accomplished by the law, gathering the intention not only from the words of the law, but from the theory of the legislation and the debates in Congress. In a great many cases, however, it is doubtful whether that intention has been carried out by the language used. Many of the questions which are and will be raised cannot be definitely answered until passed upon by the Supreme Court.

It is perhaps needless to add that the law itself should be consulted before acting in a specific case.

**Who and What is Taxed.** Broadly speaking, the law is meant to tax: (1) the income of every citizen, even if living abroad; (2) the income of every resident of the United States; (3) all income of non-resident aliens derived from sources in the United States, if the income in any of these cases amounts to over \$3,000 — the exemption, — after making certain deductions (referred to later). There are a few exceptions, such as income from bonds of the United States, the States and their sub-divisions, salaries and wages paid by the States and their sub-divisions, certain payments from insurance companies, and bequests and gifts.

The \$3,000 exemption becomes \$4,000 in the case of a

person living with his or her spouse ; but if both are taxable the added \$1,000 can only be deducted once ; and only one deduction of \$4,000 from the aggregate income of both can be made.

**Methods of Payment of Tax.** The tax is collected in three ways : (1) by payments of the person to be taxed ; (2) by payments of a representative,—for instance a guardian, who stands in the place of the person to be taxed,—on such of the latter's income as comes to him ; (3) by payments withheld and paid to the Government by some one (not a representative) who is about to pay some form of income to the person to be taxed, such as a corporation paying salary. This last — a new device in this country — is called payment at the "source."

**Nature of Tax.**— The tax is of two kinds : (1) the normal tax, being a flat 1 per cent. on all net income above the exemption ; (2) the additional tax, which is never paid at the "source," being an **extra** tax on that part of net incomes which is over \$20,000, graded as follows :

On the amount by which the net income

Exceeds \$20,000. and does not exceed \$50,000.	1 %
" 50,000. "	2 %
" 75,000. "	3 %
" 100,000. "	4 %
" 250,000. "	5 %
" 500,000.	6 %

**Deductions Allowed in Computing Taxable Income.** The deductions allowed from gross income in computing the net income which is taxable are, broadly speaking : (1) necessary business expenses (not living or family expenses) ; (2) interest on indebtedness ; (3) taxes (not against betterments) ; (4) losses not compensated by insurance ; (5) bad debts ; (6) allowance for depreciation ; and, so far as the normal tax is concerned, (7) DIVIDENDS of bodies taxable under the Corporation Income tax ; and (8) income on which another is to pay the tax at the source.

The benefit of deductions and exemptions can be obtained by taking proper steps, whether the payment of tax is made personally, by a representative, or at the source ; but it seems

that the exemption is not allowed in computing the income on which the additional tax is to be imposed.

**Method of Assessing Tax.** Assessments or computations of the tax made by the Government are based on Returns or statements of income. These are of three kinds, corresponding to the three methods of payment of the tax. For convenience, they may be called, (1) the personal return; (2) the representative return; and (3) the source return.

**Personal and Representative Returns.**

(1) The personal return, generally speaking, must be made by all persons of lawful age whose net income is \$3,000 or over, setting forth all their income and subtracting deductions and exemptions. A partner must include his share of partnership profits, even if not divided.

(2) The representative return must be made by all persons or bodies acting in a representative capacity, in all cases where the net income coming to their hands for another amounts to \$3,000 or over; the provisions applying to these returns being the same as for the personal returns. Neither, however, need include dividends from corporations, etc., taxable under the Corporation Income Tax, unless with these included the net income would amount to over \$20,000 and so be liable to the additional tax. In cases of fraud by corporations, etc., in not distributing net profits in order to evade this law, return must be made of the amount of such profits as the person would be entitled to if distributed, if such amount would bring the net income to over \$20,000.

No return is necessary either by a person or "representative" where the tax on certain income has been paid by another for him and he has no other net income. But, of course, the benefit of the exemption cannot be obtained more than once.

**Returns by a "Source."** The return by a "source" is to be made only in case the income payable to another by the "source" is in its nature fixed, determinable and periodical—a salary as distinguished from a payment for some special service. Dividends from bodies taxable under the Corporation

Income Tax are expressly excepted. The income on bonds and like obligations of corporations, etc., is to be included in a return, although it does not amount to \$3,000. In other cases no return need be made unless the income amounts to over \$3,000. Typical examples of such cases are annual salaries or rent of over \$3,000.

By the bill as finally passed, apparently the amount of the tax must be withheld from coupon interest even where the bond contained an agreement to pay coupons free of all tax. Presumably, however, the full value of the coupon must still be paid to the coupon holder.

The income from coupons, dividends and the like, payable in foreign countries, although less than \$3,000, is reached by making certain bankers and dealers in this country, who make the collection, act as "sources" in regard to such income. And those engaged in the business of making such collections must obtain a license from the Government.

**Withholding and Payment by "Source."** On all such income the amount of the tax must be withheld and later paid to the Government unless the person to whom the income is due files with the source, thirty (30) days at least before returns are due, a claim for the exemption of \$3,000 or for deductions.

**Deductions in Such Cases.** The benefit of the deductions allowed in computing net income in the other methods of payment may be obtained by the person taxed in cases of payment at the source, either (a) by filing with the "source" a return of his income from all sources and the deductions asked for (which return is forwarded by the "source" with his return); or (b) by direct application to the collector of the district in which the return is to be made—in either case at least thirty (30) days before the date returns to the Government are due.

In cases where the person taxed is unable, by reason of some incapacity, to make the necessary applications, the "source" may make them for him if he has sufficient knowledge of the affairs of the person taxed.

**Changes in Returns, Made by the Government.** Provision is made that the authorities may increase the amount

given as a return of income, if understatements are suspected. Rights of hearing and appeal are provided for. Provision is made for returns to be filed for a person by the Government in cases where it is found that a return should have been made. This may be done at any time within three years.

**Penalties, etc.** For neglect, refusal or fraud in making returns or claims, adequate penalties by fine or imprisonment or both are prescribed. For tardiness in payment of the tax an addition of 5 per cent. of the tax is made and interest at 1 per cent. per month is charged.

**Taxable Period.** The tax is on income from January 1 to December 31 in each year excepting 1913, in which the period is from March 1 only, and only five-sixths of the deductions and exemptions is allowed. But nothing is to be withheld at a "source" before November 1, 1913.

**Dates for Filing Returns and for Assessment and Payment of Tax.** All returns to the Government are due in each year on or before March 1; the tax is to be assessed by the Government and notification sent on or before June 1, and payments must be made on or before June 30.

In cases of returns made by the authorities for a person who failed to make a return, notice of the assessment is made immediately, and payment of the tax is due within ten days thereafter.

### Example

Income of Smith, a bachelor, for calendar year:

(1) Profits in business as manufacturer (see note below),	\$70,000.
(2) Salary as Treasurer of Blank Corporation . . . . .	2,000.
(3) Rent of an office building . . . . .	6,000.
(4) Dividends from Dash Corporation stock . . . . .	24,000.
(5) Dividends from Meyer Corporation (of Germany) stock . . . . .	4,000.
(6) Coupons on bonds of Brown Corporation . . . . .	1,000.
(7) Interest on United States bonds . . . . .	1,000.
	<u>\$108,000.</u>

Expenses of Smith for the same calendar year:

(8) Interest on a note given for money borrowed	.	.	\$1,000.
(9) Rent of apartment	.	.	500.
(10) Clothes, food, and household expenses	.	.	1,500.
(11) Taxes	.	.	500.
(12) Loss by fire on uninsured shed at factory	.	.	100.
(13) Business debt charged off (debtor bankrupt)	.	.	100.
(14) Charged off for depreciation of factory	.	.	5,000.
(15) Repairs on office building	.	.	1,000.
(16) Janitor of office building's salary	.	.	2,000.
			<u>\$11,700.</u>

(NOTE.— For the sake of brevity, we assume that the only factory expenses are (12), (13), and (14), and that they were not considered in figuring (1) as \$70,000.)

To compute Normal Tax

From the Gross Income of \$108,000.

Deduct

Of the Income items:

- (3), because being over \$3,000., the tax thereon will be withheld at source (the tenant); BUT NOT (2) because being under \$3,000., the source (the corporation) will not withhold tax.
- (6), since source (the corporation) withholds tax on bonds though income is less than \$3,000.
- (7), which is expressly not taxable.
- (5), because banker in the United States, collecting draft from Germany, will withhold as a source.
- (4) Government gets Normal Tax in cases of corporations in the United States by the Corporation Income Tax.

Of the Expense items:

- (8), (11), (12), (13), (14), (15), and (16), since they fall within deductions allowed; BUT NOT (9) and (10), which do not.

And deduct:

Express exemption.

TABULATION (Normal Tax, Personal Payment)

Gross income . . . . . \$108,000.

Deduct:

Total of Income items, as above	.	.	\$36,000.
Total of Expense items, as above	.	.	9,700.
Express exemption	.	.	3,000.

Smith personally will pay Normal Tax on . . . . . \$59,300.  
which at 1 per cent. equals \$593.

Having taken the benefit of the exemption and deductions allowed by the law in computing his own payment of Normal Tax, Smith cannot claim either again, so would make no claims for a reduction in payments made at the sources — on items (3), (5), and (6).

**TABULATION (Normal Tax, "Source" Payments).**

The tenant of his building therefore would withhold and pay

1 per cent. of (3) . . . . .	\$60.
The collecting banker, 1 per cent. of (5) . . . . .	40.
The Brown Corporation, 1 per cent. of (6) . . . . .	10.
Total paid at source . . . . .	\$110.
Total paid by Smith . . . . .	<u>593.</u>
Total Normal Tax . . . . .	\$703.

To compute Additional Tax

From the Gross Income of \$108,000.

(3), (5), and (6) cannot be deducted, since payments at the source are of the Normal Tax only.

(4) cannot be deducted (on the theory that corporations, in paying the Corporation Income Tax, pay the Normal Tax only).

**Deduct:**

(7), which is expressly not taxable.

Also same Expense items as in computing the Normal Tax.

The Express Exemption cannot be deducted in computing Additional Tax.

**TABULATION (Additional Tax)**

Gross income . . . . .	\$108,000.
Deduct:	
Income item (7) . . . . .	\$1,000.
Expense items as for Normal Tax . . . . .	<u>9,700.</u>
Smith will pay Additional Tax on . . . . .	\$97,300.
On which the tax is 1 per cent. on \$20,000. to \$50,000. . . . .	\$300.
2 per cent. on 50,000. to 75,000. . . . .	500.
3 per cent. on 75,000. to 97,300. . . . .	<u>669.</u>
Additional Tax . . . . .	\$1,469.

**TABULATION OF TOTAL TAX**

Smith's Income Tax would therefore be:

Normal Tax paid by Smith . . . . .	\$593.
Additional Tax paid by Smith . . . . .	1,469.
Normal Tax paid at sources . . . . .	<u>110.</u>
	\$2,172.

Smith will not have to withhold and pay, as a source, the Normal Tax on the janitor's salary, as it is less than \$3,000.

